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The Commonwealth of Massachusetts

AUDITOR OF THE COMMONWEALTH

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NO. 93-89-2

STATE AUDITOR'S REPORT
ON CERTAIN
ACTIVITIES OF THE MASSACHUSETTS STATE LOTTERY COMMISSION

GOVERNMENT DOCUMENTS
COLLECTION

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OFFICIAL AUDIT REPORT

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INTRODUCTION

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The Massachusetts State Lottery Commission (MSLC) is authorized by Chapter 10, Section 22, of the Massachusetts General Laws to raise revenues for cities and towns by conducting various lottery games. In fiscal years 1992 and 1993, MSLC collected over \$1.736 and \$1.764 billion in revenues and incurred administrative expenses of \$63.2 and \$67.3 million, respectively.

The purpose of our review was to determine whether (1) MSLC's financial activity and related items were fairly presented, (2) MSLC's financial information was presented on a basis prescribed by the Commonwealth of Massachusetts, and (3) MSLC complied with laws and regulations that may have a material effect on its financial activities.

AUDIT RESULTS

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1. Status of Prior Audit Results: Our prior report contained two issues. Our follow-up review revealed that while both issues were unresolved, the MSLC was working on corrective action.

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a. Written Procedures and Systems Descriptions: Our prior report noted that MSLC did not document in writing its administrative and accounting control systems. Chapter 647 of the Acts of 1989 establishes the minimum level of quality acceptable for internal controls at state agencies. This audit found that MSLC's written documentation for such systems was still inadequate. We recommended that MSLC update its internal control system in writing. In its response the MSLC stated that it "is currently updating its Accounting Procedures Manual and Beano Division Financial Sections."

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b. Inventory Controls over Betting Stations: Our prior report revealed that MSLC had not inventoried and tagged its betting stations and had not prepared a master list indicating their exact location. This audit found that MSLC still had not implemented adequate inventory controls over its betting stations, and we recommended that the MSLC comply with Massachusetts inventory regulation 802 CMR 6.04. In its response to our report, the Lottery indicated that betting stations are currently being inventoried.

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2. Internal Controls over Contract Compliance Administration:
Because MSLC did not have adequate policies and procedures relative to the administration of contract compliance, its advertising firm received commission reimbursement for noncommissionable items (product transportation: \$2,064; typesetting: \$2,748; and color copy: \$797; total \$5,609) for work done in-house. In addition, the advertising firm was also reimbursed \$7,542 for travel expenses that were not specified in its contract with MSLC. We recommended that MSLC 1) implement a contract payment system that provides for expenditures based on receipt of adequate backup documentation in compliance with contract terms; 2) seek reimbursement for unallowable charges; and 3) identify and recover improper commission charges and transportation costs. In response, the MSLC stated that two management changes with respect to administration of this contract caused some disruption in monitoring compliance and that it has significantly strengthened its contract administration since the audit and has received credit memos from its advertising agency for \$5,609.

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INTRODUCTION

Background

The Massachusetts State Lottery Commission (MSLC) is authorized by Chapter 10, Section 22, of the General Laws, to raise revenues for the cities and towns by conducting a lottery within the Commonwealth and to determine the type of lottery to be conducted. MSLC may establish, and from time to time revise, such rules and regulations for these activities as it deems necessary or desirable. In fiscal years 1992 and 1993 MSLC collected over \$1.736 and \$1.764 billion in revenues and incurred \$63.2 and \$67.3 million in administrative expenses, respectively.

MSLC has the authority to collect revenues incidental to running the various games. It also has the authority to disburse prizes, pay commissions to agents, and cover certain other expenses. Operating expenses, such as salaries and administrative expenses, must be appropriated by the legislature.

MSLC's Charitable Gaming Division may grant licenses to conduct "Beano" to fraternal, religious, veterans', nonprofit, and charitable organizations. The division may also license beano organizations to sell charitable gaming tickets in conjunction with the game of beano.

The administrative office of MSLC is located in Braintree.

Audit Scope, Objectives, and Methodology

In accordance with Chapter 11, Section 12, of the Massachusetts General Laws, we conducted an audit of the MSLC's financial activity and its compliance with applicable laws and regulations are the responsibility of the MSLC's management.

The purpose of our review was to determine whether (1) financial activity and related items, such as elements, accounts, or funds, are fairly presented; (2) financial information is presented on a basis prescribed by the

Commonwealth of Massachusetts; and (3) MSLC complied with laws and regulations that may have a material effect upon its financial activities. We conducted our audit in accordance with generally accepted government auditing standards.

Our audit procedures consisted of the following:

1. Study and evaluation of internal accounting controls solely to assist us in determining the nature, timing, and extent of our audit procedures, as well as to obtain an understanding of the control environment and the flow of transactions through the accounting system. Our study and evaluation was more limited than would be necessary to express an opinion on the system of internal accounting controls taken as a whole. For the purpose of our review, we have classified the significant internal accounting control in the following categories:

Cash Receipts and Disbursements
Contract Procurement
Payroll/Personnel
Property, Equipment, and Inventory

2. Review of financial records and transactions to evaluate their completeness, accuracy, and conformance with the Commonwealth's basis of accounting.
3. Other audit procedures, including tests for the MSLC's compliance with applicable laws and regulations that may have a material effect upon the MSLC's financial activities.
4. Follow-up review of previous audit results to determine whether corrective action has been taken.

Based on our review, we have determined that, except as noted in the Audit Results section of the report, MSLC has maintained its accounting records in accordance with prescribed requirements and has complied with applicable laws and regulations for those areas we reviewed.

AUDIT RESULTS

1. Status of Prior Audit Results

Our prior report contained two issues. Our follow-up review revealed that while both issues were unresolved, the MSLC was working on corrective action measures.

a. Written Procedures and Systems Descriptions: Our prior audit report noted that MSLC did not document in writing its administrative and accounting control system. To achieve a strong administrative and accounting control environment and to safeguard assets, it is essential to document the system in written form. Written documentation is needed for:

a. Internal Accounting System and Procedures:

- (1) Revenue processing and posting
- (2) Expenditure cycles, processing and recording
- (3) Departmental cost charges
- (4) Financial statement preparation

b. Instant-Ticket Inventory and Accounting Procedures:

- (1) Verification of tickets issued to sales agents
- (2) Destruction of whole or partial ticket packs
- (3) Ticket packs stolen from sales agents
- (4) Validation of tickets for prizes
- (5) Destruction of claimed prize tickets to avoid reuse
- (6) Operation of the game ticket warehouse
- (7) Testing ticket packs to ascertain predetermined winning tickets

Although there are both formal and informal procedures in the above areas, MSLC's entire system of operations, including the entire instant-ticket operation, needed to be in writing.

Without such written documentation, management cannot effectively assess the controls in place for any necessary additions or deletions. The loss of key employees whose duties relate directly to the undocumented control system could cause operating problems while replacement employees learn to operate the various manual procedures. A significant change in a system or procedure often requires a change in or strengthening of an existing control. At the

conclusion of our prior audit, MSLC indicated that it agreed with us and stated that it would, subject to the availability of funds, contract with an independent public accounting firm to produce a written procedures manual.

During this audit, we received the following MSLC's documented operations:

- a. Accounting Procedures Manual, May 1989
- b. Beano Division-Financial Sections, circa 1980

Our review indicated that in these manuals written documentation was not inclusive, was not updated on its operations, and did not provide the necessary flexibility to accommodate change. Chapter 647 of the Acts of 1989, which was passed on January 3, 1990, and became effective on April 3, 1990, establishes:

The minimum level of quality acceptable for internal control systems in operation throughout the various state agencies and departments and shall constitute the criteria against which such internal control systems will be evaluated. Internal control systems for the various state agencies and departments of the commonwealth shall be developed in accordance with internal control guidelines established by the office of the comptroller.

(A) Internal control systems of the agency are to be clearly documented and readily available for examination.

Recommendation: MSLC should update its internal control system, inclusively and in writing, including its internal accounting systems and procedures, its instant-ticket inventory, and its data processing systems. The documentation should be flexible to accommodate change.

Auditee's Response:

The Lottery is currently updating its Accounting Procedures Manual and Beano Division Financial Sections.

b. Inventory Controls over Betting Stations: Our prior audit report noted that MSLC's estimated 5,000 betting stations, costing approximately \$1.1 million, were not inventoried or tagged. These stations, which are desk-like pieces that provide a writing surface where players may mark their lottery tickets, are located at various sales agent outlets throughout the state.

This audit again revealed that there was no master list indicating the betting stations' precise location and that this equipment was still not tagged.

Our prior audit recommended that the betting stations be tagged and inventoried in compliance with the Comptroller's Policy Manual. MSLC officials expensed rather than inventoried the betting stations.

During this review we referred MSLC officials to state regulation, 802 CMR 6.04(3)(b) Fixed Asset Management Reporting Responsibilities, which states that "minor fixed assets" valued over \$100 should be inventoried and tagged.

Without adequate controls, management has limited assurance that its property is sufficiently protected against loss, theft, or misuse, which may result in additional operating costs if the missing property has to be replaced.

Recommendation: MSLC should comply with 802 CMR 6.04 (3)(b) by tagging and taking an inventory of all betting stations, as they are fixed assets with a value over \$100 each.

Auditee's Response:

All Lottery betting stations are currently being inventoried and tagged in accordance with the rules and regulations set forth in the Commonwealth's Comptroller's Policy Manual.

2. Internal Controls over Contract Compliance Administration:

Our review of the MSLC's contract with an advertising firm for advertising services revealed that the firm incorrectly received commission reimbursements of \$5,609. In addition, the firm was improperly reimbursed \$7,542 for travel expenses. Moreover, MSLC did not have adequate policies and procedures relative to the administration of contract compliance with the advertising firm.

MSLC first entered into a contract with the firm in 1983. The scope of services required by MSLC include assistance in overall marketing strategy and product positioning; creation and production of all electronic, print, direct-response, outdoor, and transit advertising; development and execution of various media plans; effective placement of advertising in all recommended media; creation and production of all point-of-sale materials; development and implementation of market, attitude, and usage research; and other related activities upon request.

The firm is compensated on the basis of a 14% gross commission on pre-approved gross media expenditures and a 16.28% mark up on pre-approved net production expenditures for advertising services, and is paid on a monthly basis at a rate of \$116,666 (adjusted quarterly to actual commission compensation). All out-of-pocket media and production costs are billed at net contractor cost.

In addition, the firm is compensated on the basis of a fixed fee for each direct-response, design, and marketing research program or project. Such fees are to be quoted in advance and mutually agreed upon before work is undertaken or costs are incurred. The firm invoices the MSLC each month for the preceding month and provides a complete breakdown of the services rendered and costs associated with each item. There is to be no commission added to miscellaneous out-of-pocket expenditures; MSLC is liable for only the actual cost of those items and services.

Our review disclosed that proper backup documentation was not included or required by MSLC or submitted by the firm before bills were paid. MSLC officials stated that specific job orders for advertising services were budgeted and that, as long as this amount did not exceed the budgeted figure by 10%, backup documentation was not requested from or provided by the advertising firm. Moreover, our review disclosed that, even when job orders

for advertising services were 10% over budget, no backup documentation was requested or reviewed.

During our review of the firm's expenditures and backup documentation, we found three classifications of expenditures that were routinely billed as commissioned items when in fact they were noncommissionable. The firm was reimbursed for the following miscellaneous expenditures:

Product Transportation	\$12,675
Typesetting	16,882
Color Copying	<u>4,893</u>
	<u>\$34,450</u>

However, product transportation, typesetting, and color copying represent miscellaneous out-of-pocket expenditures for which the Lottery is liable only for the actual cost of those expenditures or services. In addition, the advertising firm also requested and received a 16.28% markup of the \$34,450 or \$5,609 gross commission, in spite of the contract's prohibition against commissions on such expenditures.

MSLC's lack of monitoring of the firm's invoices allowed a further instance of unallowable expenditure in travel reimbursement. The contract states that the firm shall be reimbursed for travel expenses at the same rate that is authorized for state employees. However, our review disclosed that the firm received \$7,542 in reimbursement for travel expenses in excess of what would have been authorized for state employees.

Firm officials estimated that, of the \$12,675 billed as "Product Transportation" (used routinely for taxi services), 25%, or \$3,169, was for people and 75%, or \$9,506, was for package deliveries. The average cost per mile for cab services was \$1.86, as compared to the \$.22/mile rate that is allowed to state employees. Therefore a reimbursement of \$2,789 is owed to MSLC for unallowable personal transportation costs. We also determined that local delivery services were able to transport packages with regularity at

half the cost of taxi services. Therefore, an additional \$4,753 should be reimbursed to MSLC for these unallowable and uneconomical expenditures.

The lack of specific monitoring controls requiring an examination and review of invoices and a complete breakdown of services rendered and costs associated with each item permitted the firm to collect \$13,151 in unallowable costs.

Recommendation: MSLC should implement a contract payment system whereby expenditures are made only after adequate backup documentation has been submitted and reviewed, in compliance with the terms of the contract. In addition, MSLC should seek reimbursement for \$13,151 in unallowable charges (\$5,609 in noncommissionable items and \$7,542 in unallowable transportation costs) incurred. Finally, MSLC should identify and recover any improper commission charges and transportation costs paid to the advertising firm in prior years.

Auditee's Response:

The management of the Lottery's advertising contract is now under the administration of the Lottery's Advertising Manager and Assistant Director of Finance. There were two changes of management responsibility with respect to the administration of this contract, causing some disruption in the continuity of monitoring compliance. The Lottery has significantly strengthened its administration of contract compliance since the completion of the audit.

Since the completion of the audit, the Lottery has received credit memos from its advertising agency for \$5,609 for commissions incorrectly charged on typesetting, color copying services and product transportation.

The firm regularly utilizes a contract delivery service and taxi services to transport product and materials in its performance of advertising on behalf of the Lottery. The MSLC agrees that it should work with the firm to secure the most cost competitive means of transportation.

SUPPLEMENTARY INFORMATION

Contracting Out of Delivery Service:

In April 1991, MSLC contracted with United Parcel Service (UPS) to deliver instant tickets and betting supplies to the 6,000 lottery sales agents. Prior to this action, the instant tickets and betting supplies were delivered by 67 couriers employed by MSLC. Effective May 1, 1991 these positions were eliminated.

A short-term (two-month) contract was signed with UPS (the lowest-cost provider) to deliver instant game tickets and on-line supplies (betting slips, rolls of paper, and ribbons). Simultaneously, a Request for Proposal was issued for delivery services to begin July 1, 1991. After several bids were received and analyzed, UPS, the lowest-cost bidder, was awarded a one-year contract for \$960,879.

Our review of the contract for delivery services revealed that \$1,853,229 in net savings were achieved for the year. This was a result of the elimination of the courier-related positions (salaries, health insurance, retirement, unemployment insurance, personal, vacation, sick and holiday time), which yielded annual cost reductions of \$2,501,950, plus estimated annualized savings of \$312,158 for vehicle costs, fuel costs, and maintenance and repair costs, less the \$960,879, one-year contract.

